DATE: July 7, 1997

TO: Task Force C, Working Group on Business/Nonbusiness Income

FROM: John S. Warren

RE: **Correlation of Business Income Regulation And Property Factor Regulation**

In both the current business income regulation and the regulation as proposed to be amended there is a theme that the business/nonbusiness income determination and the inclusion/exclusion of property in the property factor of the apportionment formula are governed by the same principles. If property is includable in the property factor, the income it produces is business income, and vice versa. Expressions of this theme may be found at lines 115-120, 166-171, and 223-230[1] of the draft amendment to Reg. IV.(1), the business income regulation. In Reg. IV.(10) and (11) dealing with the property factor, the theme appears at lines 448-454, 470-476, 496-498, 504-506, and 512-514.

I submit the following issues for consideration:

Issue 1: Reg. IV.(10).(a) states that property used both in the regular course of the taxpayer's trade or business and in the production of nonbusiness income shall be included in the factor only to the extent that the property is used in the regular course of the taxpayer's trade or business. It goes on to state that the method of determining the portion of the value to be included in the factor will depend upon the facts of each case. This is a rule of proration.

In Reg. IV.1.(c) some examples are given of buildings used both in the regular course of the taxpayer's trade or business and in the production of income which could be either business or nonbusiness income. The conclusion reached in the examples is that if the greater part of the property is used in the regular course of the taxpayer's trade or business, then the rental income produced by the rest of the property is business income (Example (iii) at lines 181-188, the five-story building with three floors used and two floors leased out), whereas if only a minority of the property is used in the trade or business and the greater portion is leased out, the rental income is nonbusiness income (Example (v) at lines 195-204, the 20-story building with two floors used and 18 floors leased out).

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[1] Line references are to the "April 1995 Proposal" that was discussed in Dallas.

Relating these two examples to the property factor, the conclusions should be that the five-story building is fully includable, but only 2/20ths of the 20-story building is includable. If each example is extended to a sale of the building, the conclusions would seem to be that all of the gain on sale of the five-story building is business income, and only 2/20ths of the gain on sale of the 20-story building is business income.

The question is, why should a majority rule apply in one case and a pro rata rule apply in the other case? Would the regulatory scheme be more reasonable if all cases were governed by the same rule? It seems to me that the pro rata rule is imperative in the case of the 20-story building; so if there is to be one rule for all cases, it would have to be the pro rata rule. Nothing would change with respect to the 20-story building; but in the case of the five-story building, the rents from two floors would be nonbusiness income, only 3/5ths of the building would be included in the property factor, and 2/5ths of the gain on sale would be nonbusiness income. Is this a better result?

If the taxpayer had only a leasehold interest in the building in both examples, the issue of deductibility of the subrents would arise under Reg. IV.11.(b) dealing with valuation of rented property. In the example of the five-story building, the subrents from the two floors would be deducted from the rent paid by the taxpayer.

The justification for treating the income from two floors of the five-story building as business income may be found in Reg. IV.1.(c).(1) where it is stated that rents are business income if the subject property "is used in the taxpayer's trade or business *or incidental thereto* and is therefore includable in the property factor under Reg. IV.10." Presumably, renting out a minor portion of the building is seen as incidental to the taxpayer's trade or business. However, I can find nothing in Reg. IV.10. which authorizes inclusion in the property factor of property which is merely incidental to the taxpayer's trade or business. On the contrary, the concept of "incidental" conflicts with the rule of Reg. IV.10.a., described above, that property which produces both business and nonbusiness income is to be included in the property factor on a pro rata basis, not wholly included because it is incidental to the business.

Issue 2: It seems that there should also be a correlation between the two regulations in the matter of when property should be removed from the property factor and when the income it produces should no longer be deemed to be business income. But on this point there appears to be a conflict.

At lines 96-98 it is stated that income from the sale of property satisfies the functional test for business income even when the sale occurs after the taxpayer has left the trade or business in which the property had previously

functioned. In the property factor regulation (lines 470-474) it is stated that property used in the regular course of the taxpayer's trade or business shall remain in the property factor until its permanent withdrawal is established by an identifiable event. Surely the selling of the line of business in which the property had been used is an identifiable event justifying removal of the property from the property factor, and the income it produces thereafter should be nonbusiness income.

The only case authority I know of for the statement at lines 96-98 is *Appeal of Fairchild Industries, Inc.*, Cal. St. Bd. of Equal., 8/1/80, CCH Cal. Tax Rptr. ¶206-411. A division of the taxpayer had been engaged in the business of manufacturing military firearms for which it owned the patent. During that period it also licensed the use of the patent to two other manufacturers. Then it sold all of the physical assets of the firearms division to a third party. Eleven months later it sold the patent to one of the manufacturers to whom it had earlier given a limited license. The gain on the sale of the patent was held to be business income.

The argument of consistency with the property factor was raised by the taxpayer but brushed aside by the board because a patent is intangible property and intangibles are not in fact included in the property factor. This was an inadequate response to the argument. Would the board have ruled differently if the property sold had been tangible personal property? I think the *Fairchild* case is a weak reed on which to lean.

Let us turn to the case of a sale of tangible property some considerable time after the taxpayer has left the line of business in which the property had once been used. If the sale income is treated as business income, the apportionment of that income won't be influenced by the property itself (because it will not be in the property factor in the year of sale) nor by the proceeds of the sale (because they will be excluded from the sales factor under Reg. IV.18.(c).(1).). Will this make a fair apportionment of the income?

Another way of looking at the problem is this: For how long should the taxpayer's purpose in acquiring or developing the property control the classification of the income from disposition of the property after that purpose no longer exists? There is a line of authority that if a taxpayer acquires stock of another corporation with the intent of gaining control and making it a part of its unitary business but fails to gain control and ends up selling the stock, the gain or loss is nonbusiness income. In other words, it is the purpose at the time of disposition rather than at the time of acquisition that controls the classification of the income. Perhaps the rule should be that if the property was not an integral part of the business at or near the time of sale, the gain or loss should be nonbusiness income regardless of whether it had in the past been such an integral part.